



**Testimony before the ERISA Advisory Council**

**on behalf of The Vanguard Group, Inc.**

**by John Croke, Head of Multi-Asset Product Management**

**Perspectives on lifetime income solutions as a qualified default investment alternative**

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**Background:**

The Vanguard Group is a global asset management firm serving more than 20 million investors in 170 countries and has \$5.1 trillion in assets under management. Vanguard is the largest manager of defined contribution assets in the United States and one of the largest recordkeepers of employer-sponsored retirement plans, serving 1,600 employers and 4.6 million participants. By virtue of our market-leading target-date fund franchise, we are the largest manager of qualified default investment alternative (QDIA) retirement savings in our industry.<sup>1</sup> Furthermore, Vanguard has offered annuities for more than 20 years to investors as part of our broader toolkit of retirement products, advice, education, and other services intended to improve outcomes for our investors.

Our truly unique client-owned structure, in which the investors in Vanguard's mutual funds and ETFs are the owners of The Vanguard Group, enables our organization to build investment products, deliver services, and engage with stakeholders in a manner that is fully aligned to the best interests of our investors.

My name is John Croke, and I am the head of Multi-Asset Product Management for The Vanguard Group. I'm responsible for ensuring that Vanguard's approach to designing and building default investment options—which today are delivered through the Vanguard Target Retirement Funds—continue to meet the needs of the millions of investors who rely on these portfolios to build and protect their retirement. On behalf of my colleagues at Vanguard, I look forward to discussing how our industry can better help the millions of Americans seeking a more secure retirement.

**Executive summary:**

As the Council is aware, “lifetime income solution” is a term that encompasses everything from annuity contracts of different varieties, to traditional investment portfolios with embedded payout features, to plan design options that provide for systematic withdrawals, among other variations. In today's testimony, I will be principally referring to structures that include some form of annuity guarantee, including products that combine liquid investments with a lifetime income feature.

Vanguard offers the Council its perspective on lifetime income solutions as a qualified default investment alternative focusing on three important areas:

- I. Challenges associated with the recordkeeping and portability of annuity contracts.** In addition to the many technical considerations on this topic that other panelists will offer the Council, we believe it is important to view these challenges through the lens of the

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<sup>1</sup> Sources: Pensions & Investments, 2018; Morningstar, 2017; Vanguard Strategic Insight: Simfund, December 2017.



changing, increasingly transitory nature of the workforce whose members will save for retirement across several employer plans and a variety of QDIA structures over their lifetime. Further, for plan sponsors, in-plan annuity investment products can limit sponsors' ability to change plan design, service providers, and investment options. This potentially impairs the freedom of choice enjoyed by most employers and presents particularly acute challenges in instances when sponsors must execute plan design decisions following mergers, acquisitions, and other major organizational changes.

**II. Insights from Vanguard's experience recordkeeping plans that offer annuitization as a distribution option.** Outside of instances where it is legally required or a general practice in certain markets, we observe that demand for annuitization as a form of distribution from defined contribution (DC) plans is persistently low across plan sponsors and participants alike. We share similar observations from Vanguard's retail-direct annuity offer, which suggests that low levels of market demand in the DC market may not be entirely a function of the current regulatory and participant recordkeeping construct facing employer-sponsored plans.

**III. Broader considerations for building lifetime income features into a QDIA.** Beyond limitations on participant and plan sponsor flexibility and the persistently low rate of annuitization we observe across retiree households (both inside and outside of DC plans), we believe the Council and the broader regulatory community should proceed with caution when it comes to incorporating annuity features within QDIAs. We hold this view simply because there exists no one-size-fits-all answer for converting wealth into income throughout retirement. The needs and circumstances of retiree households are simply too vast and diverse to be served through a solution that applies a universal framework, while limiting flexibility, raising cost, and increasing complexity for investors. This inherent limitation of the QDIA construct should naturally draw our industry to deliver greater retirement income security to participants through other, more effective channels—including improved plan design, improved participant savings rates, and adoption of in-plan personalized advice that can guide participants through the affirmative decision to annuitize when it is truly in their personal best interest to do so.

**I. Challenges associated with the recordkeeping and portability of annuity contracts.**

Vanguard's experience administering annuities on our DC platform primarily relates to plan distributions. At present, Vanguard does not recordkeep in-plan annuities—a decision that has been informed by a variety of factors, including, importantly, very low observed demand for annuity products (which we describe in greater detail in the following section). We believe that the challenges around administering in-plan annuities and ensuring appropriate portability are fairly well documented in the industry and will be well represented by other panelists before the Council.

That said, our decades of experience administering DC plans more broadly, along with the knowledge and insights we have acquired as the largest manager of QDIA savings in our industry (including the over 50% of our Target Retirement Fund franchise that is recordkept by third-party providers) leads us to highlight a handful of important considerations on this topic:

- *Labor turnover.* The changing nature of today's increasingly mobile workforce essentially means that DC participants are often "visitors" in the plans our industry serves. Today's entrants to the workforce



will grow their retirement savings across several employer-sponsored plans and invest across a variety of QDIA structures. The lack of uniformity across lifetime income products (and their underlying insurance contracts) not only creates challenges to recordkeeping a wide variety of structures, it may also limit the ability of participants to consolidate their nest egg in their current employer's plan, or it may entail "breaking" the prior employer's QDIA by generating additional costs or causing participants to lose unrealized benefits they have already purchased in the prior QDIA. Among DC plan participants, we and other industry practitioners observe a wide range of investment acumen and engagement in investment decision-making. For the population of participants who lack the time, willingness, or ability to make complicated investing decisions on their own, existing QDIA options are valuable innovations. The liquidity, portability, generally low costs, and broad appropriateness of target-date funds are vital features not shared by structures that include an annuity component.

- *Provider flexibility.* Today most plan fiduciaries have the unencumbered ability to run independent selection processes for plan recordkeeping, investment, and other service providers. The request for proposal (RFP) process is an important tool plan sponsors use to benchmark their service providers, reduce costs, and improve service levels to participants. The current structure of annuity contracts and constraints on their portability across platforms may impair the freedom plan sponsors enjoy to execute plan design changes and select best-in-class service providers and investment options aligned to the best interests of their participants. This risk is often most acute when an employer undergoes a meaningful organizational change because of a merger, acquisition, or spin-off. Limitations on QDIA portability may significantly interfere with the ability of sponsors to effectively merge similar plans, streamline their governance and oversight processes, and capture economies of scale that benefit participants through lower costs and simplified plan design.

## **II. Insights from Vanguard's experience recordkeeping plans that offer annuitization as a distribution option.**

Outside of plans that are statutorily required to offer an annuity distribution option related to prior money purchase plans, slightly less than 1 out of 10 Vanguard recordkept plans offer annuities as a general distribution option. One-third of plans that offer this option do so for statutory reasons or as a general market practice, such as with 403(b) plans. Across plans that offer an annuity distribution option, we observe that actual participant usage is extremely small (typically less than 1%).

Further, in our more than 30 years of experience recordkeeping DC plans, we have supported a number of employers who established an annuity purchase as the default form of distribution. Despite our close partnership with plan sponsors in administering this plan design feature, we often experience notable challenges in notifying participants approaching their required minimum distribution age that their savings will convert into an annuity if they do not tell us otherwise. In those situations when participants discover only after the fact that their accounts were involuntarily defaulted into an annuity, we find that the investor experience is suboptimal. We believe this experience with "defaulted" annuity purchases should inform the broader industry debate regarding the appropriateness of annuity features in a QDIA setting.

Our observations regarding the rather low rate of voluntary investor annuitization are not unique to Vanguard's DC practice. We have offered a variety of annuity products to Vanguard retail investors outside of employer-sponsored plans for more than two decades. Across this retail client offer, we find that only 1 out of every 8 Vanguard clients who inquire about an annuity go on to fully purchase a contract. It is important to keep in mind that this relatively modest rate of adoption is derived from a small subset of investors who are interested and curious enough about annuities that they actually proactively reach out to Vanguard to learn more.



Persistently low rates of annuitization, both inside and outside of employer-sponsored DC plans, along with the complexities and administrative challenges, are important factors to weigh as our industry contemplates that potential marriage of annuities and investments within a QDIA.

### III. Broader considerations for building lifetime income features into a QDIA

Despite the challenges we listed above, Vanguard's cautiousness is grounded in a much more fundamental constraint when it comes to building any kind of default investment solution.

During the accumulation phase of the life cycle, the objectives, needs, and preferences of most investors are fairly homogeneous and are well served by broadly diversified investment portfolios designed to compound wealth through healthy levels of exposure to the equity market. However, as investors transition from accumulation to de-accumulation, the needs and circumstances of households begin to diverge and vary widely across a number of dimensions.

In addition to basic considerations like wealth levels and investor risk tolerance, many more nuanced factors come into play when forming successful income strategies in retirement, including household structure (individual, spousal, other dependents, etc.), health status, home ownership, lifestyle preferences, bequest aspirations, regional differences in the cost of living, and access to additional sources of income (part-time work, private-sector defined benefit, etc.).

Today's primary QDIA solution—the target-date fund (TDF)—is designed in a manner that acknowledges the varied and unpredictable way that investors spend down their wealth in retirement. TDFs provide a fully liquid, prudently diversified and risk-controlled portfolio intended to accommodate the wide range of needs and preferences of investors in retirement in a way that avoids limiting options or impinging upon the flexibility investors expect when they enter retirement.

To help demonstrate the difficulty in developing a universal methodology for annuitizing wealth in retirement, we offer four high-level illustrations representing a cross section of households where annuitization of basic income needs exhibits widely varying degrees of appropriateness:

- A. **Low-balance participants** (<\$200,000 of liquid wealth at retirement for a single female<sup>2</sup>). These households are unable to fully meet their most basic spending needs (food, shelter, clothing, and out-of-pocket health care) even when accounting for income from Social Security and assuming effective annuitization rates of up to 100% of household wealth. In situations where even the theoretical maximum degree of annuitization fails to cover basic living expenses, we believe these lower-balance retirees are best served by maintaining a fully liquid retirement portfolio, as even a modest cushion against unexpected expenditures in retirement is optimal to no financial cushion at all.
- B. **High-net-worth households** (>\$1 million of liquid wealth at retirement for a single female). For households with meaningful wealth at retirement, meeting basic living expenses not covered by Social Security equates to an effective drawdown rate of 3% or less per annum. Even with a conservatively allocated portfolio and modest expectations for future capital market returns, these households have the ability to largely self-insure their longevity risk and retain maximum flexibility of their financial assets to absorb any emergency expenditures in retirement and/or preserve wealth for their heirs. The purchase of an annuity for these households offers minimal utility to the household while requiring the upfront layout of a significant portion of total wealth (up to 40% of liquid assets at age 65) to lock in coverage of basic spending needs.

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<sup>2</sup> We specify gender in our illustrations, as it has important implications with respect to longevity and, in turn, the cost to purchase an annuity.

- C. **Moderate wealth with *average* health risk** (~\$500,000 of liquid wealth at retirement for a single female). For retirees at this general level of wealth and with average health-related risks, annuitization of basic living needs not covered by Social Security could be an appropriate strategy. Wealth for these households is sizeable but probably insufficient for fully self-insuring their own longevity risk. And, even after purchasing an annuity to cover basic living expenses, there remains sufficient liquidity to absorb a reasonable range of potential emergency needs in retirement.
- D. **Moderate wealth with *high* health risk** (~\$500,000 of liquid wealth at retirement for a single female with a history of heart disease). While the financial circumstances of this example are identical to illustration “C” above, there is an additional critically important fact we know about this participant—She has a history of heart disease and a higher overall level health-related risk. This means that a larger share of wealth is needed to purchase an annuity to cover higher basic living expenditures, as out-of-pocket medical expenditures (copays for doctor visits, prescriptions, etc.) are greater in this scenario. The larger outlay required to annuitize basic living expenses leaves less remaining liquidity to protect against the now above-average likelihood of emergency medical expenses less healthy retirees face (including potential private long-term care costs of \$90,000–\$100,000 per year). Accordingly, we would recommend this household maximize liquidity to protect against higher, difficult-to-predict medical expenditures and deprioritize protecting against their own longevity risk.

While these examples are fairly basic in nature, they begin to reveal the highly nuanced and very personalized considerations that need to be weighed by retirees as they navigate these fundamental trade-offs with the wealth they have spent their entire working lifetime to accumulate. We believe that annuities have the potential to improve retirement outcomes for a small subset of households in retirement. Annuitization strategies are far from universally appropriate across households and in certain instances, can result in financial harm to certain households, significantly impairing their attractiveness as a default investment designed to meet the needs of the vast majority of retirees.

The appropriateness and effectiveness of an annuitization strategy in any of the above examples could have been materially shifted by the inclusion of one or more additional facts: Is the participant married? Are they supporting any other dependents? Do they own their home? What are their lifestyle aspirations in retirement? And so on. As designers of default solutions in DC plans, we have, at best, a narrow, fragmented, and incomplete view into the financial picture of the millions of current and future retirees we serve—a critical limitation that cannot be overlooked as our industry explores this topic.

Before embarking on the path of facilitating the greater use of annuities within QDIAs, we strongly encourage the regulatory community to consider the appropriateness of applying a universal, one-size-fits-all solution to a problem that—as we hopefully demonstrate above—is anything but one-size-fits-all. Outside of managed account offerings utilized by appropriately engaged participants, most QDIA products are an inherently limited construct. We are charged with building a solution based upon one piece of data we know about the investor we are serving and one piece only—the approximate year the investor might retire.



While QDIAs may have their limits, we are encouraged by the opportunity to continue improving retirement income security. We believe our industry will be best served by first applying its focus to other avenues of plan design where we can potentially enhance retirement income and security, including, where it is appropriate, facilitating the greater adoption of lifetime income products for that subset of households that will truly benefit from their structure. These broad opportunities, which are primarily a function of improved plan design and are largely achievable within our current regulatory framework, include encouraging plan sponsors to:

- Remove age restrictions and mandatory cash-outs.
- Consider greater withdrawal flexibility for their retired participants.
- Allow for incoming rollovers.
- Offer investment options oriented specifically to their retiree population.
- Provide enhanced advice and education that may include annuitization options.

### **Concluding remarks**

On behalf of my colleagues at Vanguard, I would like to thank the Council for asking us to share our thoughts on this very important topic. Ensuring that our industry continues to take a deliberate, thoughtful approach to designing and administering qualified default options within the defined contribution system is of the utmost importance to us.

We estimate that today, a little more than 50 cents of every dollar contributed to a DC plan in our country is directed toward the plan's QDIA. We firmly believe that investors in today's default investments have benefited tremendously through vastly increased access to globally diversified, professionally managed, low-cost investment portfolios. Given their role in plans today and their likely role in the years to come, the continued evolution of QDIA design carries tremendous promise but also tremendous risk. This risk can be mitigated by preserving and building upon the characteristics of QDIA design that have most driven their success to date: low costs, transparency, liquidity, and full revocability, all with an approach that is appropriate across a very wide set of investor circumstances.